

The Commonwealth Corner – Investor Updates

Auction Rate Securities

What's all the controversy over auction rate securities ("ARS")? These long-term financial instruments (investment products) include a component that may provide for quick, short-term access to the cash value of the investments; otherwise known as liquidity. ARS are constructed from pools of municipal bonds, corporate bonds, educational loans, and preferred stocks. The bonds themselves have maturities that can range from five years to perpetuity. ARS interest rates are variable as they were periodically re-set through "Dutch" auctions, typically every 7, 14, 28, or 35 days. As long as these auctions did not fail, they provided liquidity to ARS holders. Introduced in the US markets in the early 1980s due to borrowing constrictions in the financial markets, the popularity of these investments sky-rocketed to what was reported to be well over a \$300 billion market by early 2008.

Institutional investors seeking liquidity and above-market returns contributed greatly to the steady rise in the ARS market. Once the benefits became known, smaller net worth clients became attracted to ARS. These investors were largely unaware of the liquidity risk. ARS were allegedly marketed and sold as "money market equivalents" or "cash equivalents" to investors, which meant that the investments could quickly be converted to cash. Financial advisors and brokers sold ARS to clients in \$25,000 units, earning commissions that continued to accrue for as long as the investors held their ARS. Investors throughout the United States may have been told that ARS were "just as good as cash" and just as safe as any money market investment.

In February 2008, liquidity evaporated in the ARS market as the Wall Street firms and other financially-savvy players left the playing field by failing to support the market. Instead of successful auctions occurring where the number of buyers at least equaled the number of sellers, the opposite occurred, leading to unsuccessful auctions. A variety of market analysts theorize that extraordinary turmoil in the banking system due to the sub-prime crisis is the primary reason for the ARS market collapse. While that potentially is correct, factors such as poorly collateralized ARS and insurance companies denouncing potential obligations due to failed auctions further drove the market to turmoil.

As ARS demand sharply declined, investors holding ARS were left "holding the bag" with no demand for their investments. Broker-dealers can not remit cash values for illiquid holdings and are alleged to have denied investors from engaging in third-party transactions aside from their respective brokerage firms. Some broker-dealers are lending investors up to 100% of their ARS balances at preferred interest rates on margin. Margin is a business practice where broker-dealers loan its customers money and the collateral for the loan is the value of securities in customer accounts maintained by the broker-dealer. As demand continues to plummet for ARS, broker-dealers are lowering the value of ARS holdings where margin debt is present, which reduces the value of the collateral. As the value of collateral

declines, broker-dealers require more equity (cash/other securities) to be deposited in margin accounts to counter-balance the amount of debt tied to the equity.

Should the US markets continue to decline, the possible outcomes of this spiral are unknown. More and more investors are attempting to redeem their ARS holdings, but broker-dealers can not or will not market the securities or remit funds to investors. One thing to remember is that ARS are backed by pooled, debt-instrument assets. Some could default prior to maturity while many issuers (municipalities and non-profit organizations) will continue to meet their obligations as they can afford to pay them, even at higher interest rates. As interest rates rise, the payment auction rate issuers have to pay will increase as well. If investors can hold for the long-term, their ARS may yield a higher return than initially contemplated. However, the risk of default still looms.

Industry specialists with various financial institutions are attempting to craft alternative products. One product has been constructed and approved by the United States Securities & Exchange Commission and the United States Department of Treasury. Only time and demand will tell if this is a viable alternative.

Virginia investors must be cautious when dealing with ARS and other complex investment products. Any investors in the Commonwealth should feel free to contact the Division of Securities & Retail Franchising if they have experienced any difficulties with their ARS or any other investment products. Our contact data is located on the homepage; <http://www.scc.virginia.gov/srf>.

You may also visit <http://www.nasaa.org> to review more information regarding ARS.

Remember, invest wisely; and if an opportunity sounds too good to be true, then it probably is!